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COMMENTS ON RECENT GOVERNMENT'S PROPOSAL TO REFORM UKRAINIAN TAX SYSTEM

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INTRODUCTION

Tax policy is a key element of overall government's fiscal policy strategy. The main purpose of taxation is to finance the provision of public services. As a consequence, revenue collection serves as a constraint on government spending. Besides financing the government's expenditure taxation reflects also other following roles:

- redistributive measure, as public benefits are not in proportion to individual taxpayers contributions;
- incentive measure, as tax policy impacts real economic activity through influencing propensity to save, invest and work.

In general, tax system is one of important factors in determining the overall efficiency of the economy. Almost all transition economies have already recognized these consequential interactions. Tax reform has became a vital component of the "quality" of public finances not only in the European Union countries (where such need was expressed and underlined during recent special European Council in Lisbon) but also in many Central and East European (CEE) countries.

For years, Ukraine has been facing very considerable problems in conducting healthy fiscal policy. As a result, revenue collection has been weak and actual revenue has always been consistently lower than plan. Recently, the new government has recognized the necessity of substantial improvements in this field. Tax reform has been incorporated into government's action program for 2000 year entitled "Reform and Prosperity" as one of the main priorities for economic policy strategy. In general, the government declared its commitment to transform Ukrainian tax system in order to guarantee the background for sustainable economic growth.

The actual understanding manifested itself in the form of the government's draft Tax Code. The government's draft is to be examined by the Verkhovna Rada soon. However, the progress in the works may be expected to be relatively slow, mainly because it could be very difficult to reach a consensus over the final version of tax system.

The purpose of this study is to analyze the government's attempts to modify the prevailing tax system. The main features and characteristics of tax reform recently proposed will be summarized. The study will aim at evaluating the prospects for establishing tax system that would produce stable revenue without a negative incidence on economic growth. To fulfill these tasks next section briefly describes characteristics of good tax system. The following section examines the evolution of Ukraine's tax revenues and fiscal balance relative to GDP since 1992 and compares developments with those in the other CEE countries. Further, the main features of proposed tax system are discussed. Finally weaknesses and risks of proposed tax system implementation are outlined. The study concludes with a set of recommendations.

PRINCIPLES OF OPTIMAL TAX POLICY AND TAX REFORM IN TRANSITION ECONOMIES

The basic ideas of good taxation and the desirable characteristics of tax system have been thoroughly examined by several economists. There are four maxims with regard to taxes:

- *equality*: that people's tax payments should be in proportion to their income;
- *certainty*: that tax liabilities should be clear and certain, rather than arbitrary;
- *convenience of payment*: that taxes should be collected at a time and in a manner that is convenient for the taxpayer;
- *economy in collection*: that taxes should not be expensive to collect.

In general, the principles of good taxation are identified as an equitable, efficient and simple tax system. The distribution of the tax burden should ensure equal fiscal treatment of incomes of equal amounts (horizontal equity) and certain graduality in the distribution of the tax burden between taxpayers with different levels of taxable income (vertical equity). Great consideration is being paid to the distortional effects of taxation and the need to minimize its disincentive effects on labor supply and discouragement of business activity. The simplicity requirement is understood as the tax system that ensures minimization of administrative costs.

These basic ideas have also been applied to the problem of tax reform in transition economies. The main goal of tax reform should be to develop a tax system compatible with market economy principles and meeting the following requirements:

- Ensuring revenue-generating capacity reflecting the responsiveness to GDP growth (increase in revenue relative to growth in nominal income without frequent changes in tax rates or introduction of new taxes).
- Efficiency (allowing for undisturbed allocation of resources).
- Transparency (stable, predictable, clearly drafted and well defined tax law).
- Reasonable overall tax burden (too high a tax burden can encourage tax evasion and distortions in the economy).

GENERAL CHARACTERISTICS OF UKRAINIAN TAXATION SYSTEM - LEVELS AND STRUCTURE

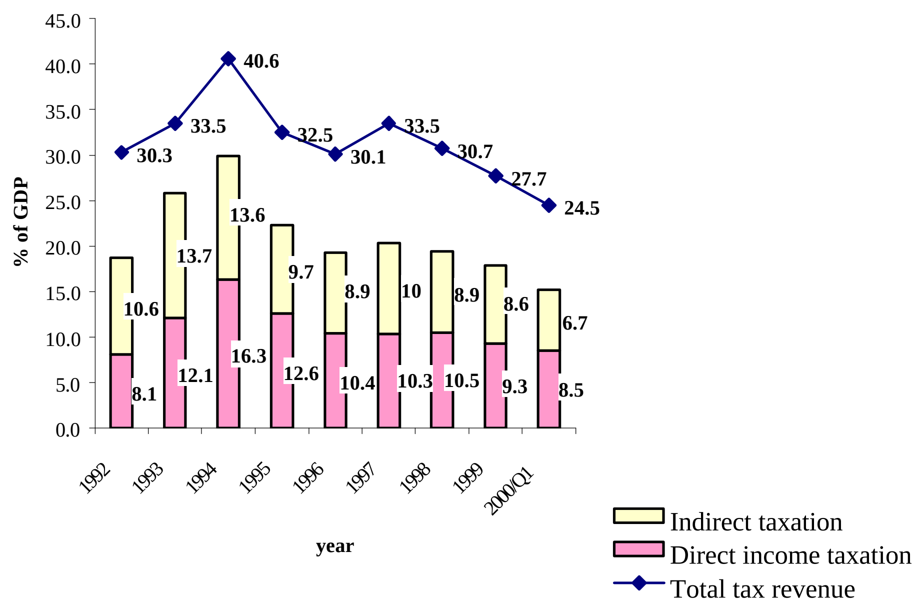
The evolution of Ukrainian tax revenues and fiscal balance relative to GDP since 1992 are shown in Table 1. Data show that country has been experiencing a **continuos deterioration of tax revenue/GDP ratio** – from about 40 % in 1994 to nearly 28 % in 1999 (year 1997 being an outliner when the ratio increased to 33.5%), and it is estimated to remain at that low level also in 2000. Despite the relatively high overall tax burden – on average 32% of GDP during the analyzed years – the fiscal deficit was large, yet declining. It ranged from 10.5% of GDP in 1994 to 1.4% of GDP in 1999. Considerable tax burden is not surprising taking into account that the need for revenue reflects the level of government spending. However, total taxation revenues in Ukraine measured as share in GDP remain well below the average representative for countries on more advanced transformation stage. For example average for Poland, Czech Republic and Hungary amounts to about 40% of GDP. This indicates that the revenue potential of this mechanism is yet to be fully exploited. There is a strong need for substantial improvements in revenue collection considering necessities related to reforms that Ukraine's economy has to undergo yet.

TABLE 1. TAX REVENUE AND FISCAL DEFICIT 1991 – 2000/Q1, in % of GDP

Tax	1992	1993	1994	1995	1996	1997	1998	1999	2000/Q1
Households income tax	2.7	2.0	3.1	3.1	3.4	3.8	3.8	3.7	3.6
Enterprise profit tax	5.4	10.1	13.2	9.5	7.0	6.5	6.7	5.6	4.9
Pension Fund	9.2	5.9	8.5	8.2	8.9	11.2	9.8	9.6	9.2
VAT	9.4	11.9	12.0	8.9	8.1	8.7	7.6	7.1	5.7
Excise taxes	1.2	1.8	1.6	0.8	0.8	1.3	1.3	1.5	1.0
Other - Chernobyl tax	2.4	1.8	2.2	2.0	1.9	2.0	1.5	0.2	0.1
Total tax revenue	**30.3**	**33.5**	**40.6**	**32.5**	**30.1**	**33.5**	**30.7**	**27.7**	**24.5**
Fiscal balance	**-12.2**	**-6.5**	**-10.5**	**-7.9**	**-4.9**	**-7.1**	**-2.1**	**-1.4**	**3.4**

The burden of direct and indirect taxation and its changes over time is illustrated on the following Figure 1.

FIGURE 1. TAX REVENUE DEVELOPMENT SINCE 1992, in % of GDP



As the **importance of direct income taxes** is concerned Figure 1 shows that revenues from that source as a proportion of GDP have **declined** nearly two times since 1994. The total direct taxes ratio estimated at 16.3% of GDP in 1994 has been steadily decreasing to the level of 9.3% of GDP in 1999. Analyses of the weight of particular tax categories in the structure of direct taxation reveal that revenue **loss from taxes on enterprise profits accounted for the larger share of the decline in revenues**. Share of personal income taxes in GDP remained roughly constant at the level of about 3.5% of GDP. Corporate income tax revenues decreased from 13.2% of GDP in 1994 to 5.6% of GDP in 1999. Although the personal income tax has remained stable in relative importance as a source of revenue, its contribution to GDP is still lagging not only behind market economies but also several CEE countries (approximate average for EU countries – 11% of GDP, for CEE – 7% of GDP).

It is readily seen that presented data highlight another one considerable weakness of Ukrainian taxation system. In the analyzed period the **share of indirect taxes revenues declined to only 6.7% of GDP**. Furthermore, very unfavorable/dangerous trend has developed. It appears that Ukraine bases its fiscal revenues on the indirect taxation to a very limited extent only. Indeed, the **revenue productivity of indirect taxation has been decreasing and has been considerably surpassed by performance of direct taxation since 1993**. This seems to be a crucial shortcoming of the Ukrainian tax system. As indirect taxes can at least partly affect the shadow economy, they should constitute the main source of budget revenues.

MAIN FEATURES OF NEW TAX SYSTEM

Recently, the Cabinet has developed a new draft Tax Code, which foresees tax system with the following main characteristics:

- First the number of tax categories is to be reduced from current 36 to 13 on national level and 10 on local level.

- Second, the biggest changes have been made to the scale for calculating personal income tax. There are currently five rates: 10%, 15%, 20%, 30%, and 40%. It is proposed to have only two: 10%, and 20%. The project foresees the introduction of tax free amount for each taxpayer estimated at minimal salary. Tax brackets are to be indexed each year. Tax scale is to has the following form: incomes up to 6480 Hr are to be taxed according to 10 % rate, above 6480 Hr - according to 20 %.

- Gradual reduction of current 30 % CIT rate is proposed:
    - 25 % during the first year of tax reform
    - 20% beginning from the second year.

- The draft code proposes to introduce a combined VAT rate, lowering the rate from 20% to 17% + 2% for innovation fund in the first year of tax reform, and 15% + 2% in the second year. Zero rate for exports is to retain.

- The Cabinet proposes to reduce the list of goods subject to excise tax to only five main categories.

MAIN WEAKNESSES AND RISKS OF IMPLEMENTATION

According to the government's assumptions and objectives tax reform is to ensure provisions for stimulating economic and structural transformation. As far as very broad overview of tax system framework is concerned it appears to a very limited extent meet these requirements. The project exhibits substantial shortcomings and weaknesses, which can be expected to negatively influence effectiveness, neutrality, transparency and simplicity of new tax system.

1. First of all, **proposed tax reform is going to result in the reduction of overall tax revenues into budgets 2001 and 2002**. It may seriously threaten the provision of expenditures at the level compared with at least current one. In the following years one cannot expect substantial reduction of spending related to social and structural expenditures. Tax reform in the proposed shape poses considerable constraint on the possibility of meeting those commitments.

2. Second, the following table shows that **tax reform** designed in a way proposed by the government **will bring fiscally unbalanced results**.

TABLE 2. REVENUE EFFECTS IN 2001 AND 2002
(effect in comparison to budget revenues expected under unchanged tax system prevailing in 2000)

TAX CATEGORY / TAX RATE	BUDGET 2001	BUDGET 2002
PIT 10/20	⇓	⇓
CIT	25% ⇓	20% ⇓
VAT	17% + 2% ⇑	15% + 2% ⇓
EXCISE	⇑	⇑
TOTAL	ß	ß

Implementation of **proposed tax system might contribute to the widening of budget deficit**. It should be strongly underlined that those losses should absolutely not be compensated by the means of privatization revenues (as is expected by some authorities). According to the IMF standards privatization receipts are not considered as budget revenues and should not be classified as such. Furthermore, privatization receipts have temporary character and cannot serve as a sustainable source for budget balancing in long term. The possibility of facing unbalanced budget next years may negatively influence talks and negotiations with international donors.

3. As far as PIT is concerned, it is noticeable that introduction of only two tax rates reflects substantial flattening of PIT scheme. In general, it can be considered a positive step, as the effectiveness of current top marginal rate of 40 % is very limited. However, taking into account the structural specific of the distribution of population by monthly income per capita and proposed PIT scale more than 70 % of population is expected to pay income taxes according to the minimal 10 % rate. In addition, PIT legislation continues to allow for huge number of social exemptions (children allowances, disabled allowances, specific deductions for war veterans and Chernobyl victims, etc). The maintenance of this generous and controversial schemes combined with tax free amount equal to minimal salary may result in **considerable reduction of effective tax rate below even 6 %**[1]. The existence of several social exemptions creates relieves related corruption, complicates PIT administration and reduces budget revenues. Distribution of social aid should not be conducted by tax policy but by the means of targeted compensation. In general, reduction in PIT rates is not accompanied by sufficient elimination of tax exemptions. Furthermore, the flattening of tax schedule does not guarantee immediate increase in compliance of current shadow economy.

4. **VAT rate is to be reduced too early and in the extremely sharp manner**. These unfavorable developments are additionally accompanied by very expand system of VAT exemptions. In principle, huge number of eligible VAT privileges may create legislation loopholes and add to decreased effectiveness of tax administration. Wide range of VAT relieves on several categories of services limits tax base. Introduction of a combined VAT rate with 2 % going to innovation fund appears to be questionable and controversial proposition. VAT system should not be used for the purposes of special budget funds' creation. Proposed solution only increases complexity of tax system and tax administration, while being of very limited revenue effectiveness.

RECOMMENDATIONS

Description and comments presented in the previous sections shows the way in which a new tax system is to be built up. From the point of view of complexity and the lack of transparency characteristic for the current taxation regime surely the case for the tax reform in Ukraine is very strong. However, government's project appears to be too radical and liberal as for the current circumstances in Ukrainian macroeconomic situation. It also poses substantial threat over developments in budget process during following years. There are justified doubts whether tax reform in the proposed version can be expected to have favorable impact on budget revenues and positive efficiency and growth effects.

Generally, tax policy measures and changes should aim at the following principal objectives:

[1] It is only approximate estimation, which needs to be confirmed by further calculations. But it gives the proper idea about the magnitude of influence.

1. The most important is that **tax reform should bring fiscally balanced effects**. It should guarantee budget revenue generating (or at least neutral for current level of budget revenues) structure of tax system. Taking into account all social expenditures as well as expenses related to structural changes Ukrainian government is going to face in coming years there is no possibility to further reduce budget expenditures. Due to, any tax system changes should result in, at least, keeping budget revenues at current level in relation to GDP.

2. In longer term perspective, **eventual reduction in tax burden unless accompanied by offsetting spending retrenchments may not be sustainable**. Only a tax cut offset by a reduction in government consumption is likely to have a positive economic impact as tax reform is self financing only in the limited degree[2]. Otherwise it would entail deterioration in the budget balance leading to the increase in the budget deficit.

3. Flattening of PIT scheme should be introduced more gradually. **The reduction in PIT rates should be accompanied by complete elimination of numerous exemptions** and privileges (especially those of social character), which could lead to broadening and "clearing up" of tax base. Together with the proper design of tax brackets it should aim at guaranteeing effective tax rate possibly higher than 10 %.

4. **Reduction of CIT rate should be implemented gradually** (by a few percentage points per year) and follow clear schedule for period of time much longer than two years. As a result, CIT rate should be consistent with top marginal PIT rate to eliminate discrepancy in treatment of incomes derived from different sources.

5. **Possible budget losses** from the reduction of direct taxation burden have to be **compensated and offset by increase of VAT and excise revenues**. To some extent, shift from income to indirect taxes represents also a possible alternative to expenditure reduction. **Basing budget revenues on indirect taxation should be considered as a priority for Ukrainian tax reform**. In order to stimulate and accelerate higher flows from VAT (the main indirect tax) very though elimination of tax relieves should be implemented. In addition, eliminating most of VAT exemptions granted currently to numerous services should lead to broadening of tax base. It is strongly recommended that VAT rate should remain at the current level of 20 %. Introduction of lower VAT rate is related with very considerable decline in budget revenues from this source. Furthermore, VAT rate should be uniform, without division into two rates related to budget revenues and creation of innovation fund respectively.

6. In general, **considerably higher weight should be assigned to the indirect taxation**. The indirect taxes have substantial advantage in comparison to direct taxation – they enable to more efficiently and effectively tax shadow economy. This argument appears to be of special importance in the case of Ukraine while considering a decisive tax reform.

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[2] According to the estimates by European Union Commission Services conducted for EU countries tax reform without offsetting spending cuts is self financing in only about 25%.